STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

RICK SNYDER
GOVERNOR

ANDY DILLON
STATE TREASURER

DATE: August 2, 2013

TO: Governor Snyder

FROM: Pontiac School District Financial Review Team:
John Axe
John Barton
Max Chiddister
Frederick Headen
Doug Ringler
Carol Wolenberg

SUBJECT: Report of the Pontiac School District Financial Review Team

On July 10th, 15th, 17th, and 24th, Pontiac School District Financial Review Team members met and reviewed information relevant to the financial condition of the Pontiac School District. Based upon that review, the Review Team concludes, in accordance with Section 5(4)(b) of Public Act 436 of 2012, the Local Financial Stability and Choice Act, that a financial emergency exists within the Pontiac School District.

I. Background

A. Preliminary Review

On April 23, 2013, the Michigan Department of Education commenced a preliminary review of the finances of the Pontiac School District to determine whether or not probable financial stress existed. Section 4(1) of the Act permits a preliminary review to be conducted if one, or more, of the conditions enumerated therein occurs. The preliminary review of the Pontiac School District resulted from the conditions enumerated in subdivisions (k), (n), (o), and (s) of Section 4(1) having occurred within the School District.[1]

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[1] Subdivision (k) provides that "[t]he local government fails to timely file an annual financial report or audit that conforms with the minimum procedures and standards of the state financial authority and is required for local governments under the uniform budgeting and accounting act, 1968 PA 2, MCL 141.421 to 141.440a, or 1919 PA 71, MCL 21.41 to 21.55." Subdivision (n) provides that "[t]he local government is in breach of its obligations under a deficit elimination plan or an agreement entered into pursuant to a deficit elimination plan." Subdivision (o) provides that "[a] court has ordered an additional tax levy without the prior approval of the governing body of the local government." Subdivision (s) concerns "[t]he existence of other facts or circumstances that, in the state treasurer's sole discretion for a municipal government, are indicative of probable financial stress or that, in the state treasurer's or superintendent of public instruction's sole discretion for a school district, are indicative of probable financial stress."

To facilitate preliminary reviews of school districts, the Michigan Department of Education has developed critical factors to determine whether probable financial stress might exist in a school district. Those factors are:

1. A school district has been in a deficit condition for three or more consecutive years (including the current year); and

2. A school district's existing deficit is greater than 15 percent of general fund revenues, excluding incoming transfers; and

3. A fiscal review by one of the Department [of Education]'s program offices or an external auditor has revealed one or more material internal control weaknesses as evidenced by notes or findings in a financial audit related to any of the following:

   (a) A lack of written policies and procedures or failure to follow the written policies and procedures.

   (b) Poor cash management.

   (c) A failure to provide personnel activity reports for employees paid with federal funds.

   (d) A history of spending outside appropriations established by the local school board in violation of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act.

   (e) The use of grant funds on unallowable expenditures.

   (f) Going concern issues, or a qualified financial audit opinion, or both; and

4. A school district shows unsatisfactory progress in eliminating a deficit. This is determined by identifying one or more of the following conditions:

   (a) A deficit increase from the previous year.

   (b) Lack of cooperation from school district officials in submitting deficit information (i.e., late submission of deficit elimination plans, delinquent return of phone calls or correspondence relating to deficit elimination plans, and chronic late submission of monthly budgetary control reports).

   (c) A history of supplying the Department of Education with deficit elimination plan information which either was inaccurate or inconsistent with actual revenues and expenditures at year end.

5. A school district fails to comply with bond or note covenants or fails to make pension fund deposits.

Based upon the foregoing critical factors, the preliminary review found, or confirmed, the following for the School District:

- The School District had shown unsatisfactory progress in eliminating its cumulative general fund deficit. That deficit had increased from $8.5 million on June 30, 2009, to $37.7 million on June 30, 2012. School District officials projected that the School District would remain in a deficit condition during the 2013 and 2014 fiscal years.

- The fund balance of the School District, expressed as a percentage of general fund revenues was a negative 52 percent on June 30, 2012 (the most current audited data). This percentage far exceeded the Department of Education's parameter of a negative 15 percent to indicate concern.

- The financial audit report of the School District for the 2012 fiscal year included 10 findings of material weaknesses, significant deficiencies, or noncompliance. The financial audit report of the School District for the 2011 fiscal year had included 14 findings of material weaknesses, significant deficiencies, or noncompliance.

- The School District was delinquent in remitting retirement contributions to the Michigan Public School Employees Retirement System in the amount of $2.7 million for the period ending March 31, 2012.

In addition to the foregoing preliminary review findings for the School District, the Michigan Department of Education gave consideration to the following information:

- The School District did not file its most recent financial audit report with the Department of Education by the statutory due date of November 15, 2012. As a result, the Department was statutorily required to withhold State school aid payments beginning in December 2012.

- The Department rescinded its approval of the School District's deficit elimination plan due to the failure of School District officials to implement agreed upon strategies to reduce the fiscal year 2012 deficit to the level projected in that plan. The Department was then statutorily required to withhold State school aid payments beginning in March 2013.

- The School District submitted to the Department of Education on May 6, 2013, a revised deficit elimination plan which the Department approved, but with significant contingencies.

- Cash flow continued to be distressed to a level that necessitated the School District receive current year advances from Oakland Schools (i.e., Oakland County's intermediate school district) in order meet payroll, and other financial, obligations.

- The School District had a longstanding history of turnover in administrative leadership, which hampered, among other things, a consistent, stable, and ongoing implementation of deficit elimination plans.

- The School District had a $7.8 million judgment entered against it on January 18, 2013, due to its failure to remit payments to the Michigan Education Special Services Association. The judgment was placed on the School District tax rolls as a judgment levy beginning in July of 2013.

On May 20, 2013, the Superintendent of Public Instruction submitted the foregoing preliminary review to the Local Emergency Financial Assistance Loan Board. On June 6, 2013, the Local Emergency Financial Assistance Loan Board determined that probable financial stress existed for the Pontiac School District.[2]

B. Review Team Findings

On July 3, 2013, the Governor appointed a six-member Financial Review Team. The Review Team convened on July 10th, 15th, 17th, and 24th, 2013.

1. Conditions Indicative of a Financial Emergency

The Review Team found, or confirmed, the existence of the following conditions based upon information provided by School District officials, or the School District's audit firm, or other relevant sources:

- According to the School District's 2012 fiscal year financial audit report, the School District's cumulative general fund deficit increased by 53.6 percent, from $24.5 million on June 30, 2011 to $37.7 million on June 30, 2012. The one-year increase in the School District's cumulative general fund deficit resulted from general fund expenditures and net transfers out exceeding general fund revenues by $13.1 million.

- On July 11, 2013, the Michigan Public School Employees Retirement System notified the Superintendent of Public Instruction and State Treasurer to withhold $4.9 million in State school aid payments from the School District due to its failure to remit employer and employee contributions for the period ending June 30, 2013. Public Act 300 of 1980, the Public School Employees Retirement Act 1979, requires the Superintendent of Public Instruction and State Treasurer to withhold State school aid upon written notice from the Retirement System.

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[2] Under the prior emergency management statutes (Public Act 101 of 1988; Public Act 72 of 1990, the Local Government Fiscal Responsibility Act; and Public Act 4 of 2011, the Local Government and School District Fiscal Accountability Act), a preliminary review reached a conclusion regarding whether a serious financial problem or probable financial stress existed in the unit of local government that was subject to the review. However, under the current Act, a preliminary review reaches no such conclusion. Instead, pursuant to Section 4(2) of the Act, "[t]he state financial authority [the State Treasurer or Superintendent of Public Instruction] shall prepare and provide a final report detailing its preliminary review to the local emergency financial assistance loan board…Within 20 days after receiving the final report from the state financial authority, the local emergency financial assistance loan board shall determine if probable financial stress exists for the local government."

- School District officials violated Section 17 of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, by permitting expenditures in excess of budgeted appropriations.[3] Over expenditures during the 2012 fiscal year are depicted by program area in **Table 1**.

Table 1

Excess of Expenditures Over Appropriations in Budgeted Funds
2012 Fiscal Year

Program Area	Budget	Actual Expenditure	Over Expenditure
Instruction	$43,373,360	$46,813,978	($3,440,618)
Pupil	$5,865,840	$8,861,536	($2,995,696)
Instructional Staff	$3,188,724	$3,855,481	($666,757)
General Administration	$1,248,024	$1,277,313	($29,289)
School Administration	$3,766,990	$4,210,559	($443,569)
Business	$3,730,406	$5,110,611	($1,380,205)
Pupil Transport Services	$3,980,683	$4,447,541	($466,858)
Central Office	$1,641,856	$2,170,547	($528,691)
Total	$66,795,883	$76,747,566	($9,951,683)

Source: 2012 Annual Financial Audit

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[3] Section 17 of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, reads, in part, as follows:

> (1) Except as otherwise provided in section 19, a deviation from the original general appropriations act shall not be made without amending the general appropriations act. Subject to section 16(2), the legislative body of the local unit shall amend the general appropriations act as soon as it becomes apparent that a deviation from the original general appropriations act is necessary and the amount of the deviation can be determined. An amendment shall indicate each intended alteration in the purpose of each appropriation item affected by the amendment. The legislative body may require that the chief administrative officer or fiscal officer provide it with periodic reports on the financial condition of the local unit.
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> (2) If, during a fiscal year, it appears to the chief administrative officer or to the legislative body that the actual and probable revenues from taxes and other sources in a fund are less than the estimated revenues, including an available surplus upon which appropriations from the fund were based and the proceeds from bonds or other obligations issued under the fiscal stabilization act, 1981 PA 80, MCL 141.1001 to 141.1011, or the balance of the principal of these bonds or other obligations, *the chief administrative officer or fiscal officer shall present to the legislative body recommendations which, if adopted, would prevent expenditures from exceeding available revenues for that current fiscal year*. Emphasis supplied.

- As depicted in **Table 2**, financial audit reports for the School District for its last three fiscal years reflect significant variances between general fund revenues and expenditures, as initially budgeted and as amended, versus general fund revenues and expenditures actually realized. In all three of the years in question, general fund revenues were overestimated, substantially so in fiscal years 2010 and 2011, by 11.1 percent and 12.7 percent, respectively. It is noteworthy that in none of the three years did general fund revenues exceed general fund expenditures.

  These significant variances between budgeted revenues and expenditures and actual revenues and expenditures, in concert with an apparent inability of School District officials to accurately monitor revenues and expenditures throughout a given fiscal year and to then amend School District budgets accordingly, rendered the adopted budgets, and in many instances the amended budgets, effectively meaningless as a financial management tool. Certainly, annual budgets proved to be an ineffective bulwark against unauthorized expenditures because in only one year, 2010, were actual expenditures less than what had been budgeted.

Table 2

General Fund Revenues as Initially Budgeted, Finally Budgeted, and Actual

	2009-10	%	2010-11	%	2011-12	%
Revenues						
Original	$85,635,487		$84,147,521		$73,736,153	
Final	$87,581,882		$84,147,521		$74,541,277	
Actual	$77,890,627		$73,426,458		$72,721,182	
Variance	($9,691,255)	(11.1)	($10,721,063)	(12.7)	($1,820,095)	(2.44)
Expenditures						
Original	$83,214,020		$80,102,754		$70,375,653	
Final	$87,311,020		$80,102,754		$74,363,724	
Actual	$79,450,628		$84,085,237		$83,897,204	
Variance	$7,860,392	9.0	($3,982,483)	(4.97)	($9,533,480)	(12.8)

Source: Annual Financial Audits

- The Review Team was advised that School District officials viewed as paramount satisfying biweekly payroll obligations. To this end, those officials appear to have adopted a strategy of pooling all cash resources so that those resources could be used to satisfy payroll obligations. However, this strategy was pursued without regard for the fact that a number of the resources that had been pooled together were prohibited by legal or accounting requirements from being utilized for general operations such as payroll.

As but one specific example, School District officials utilized debt retirement funds to satisfy School District payroll obligations, which was a manifest violation of State law. The circumstances surrounding this matter warrant further inquiry by appropriate authorities.[4] Furthermore, based upon information considered by the Review Team, this misuse of debt retirement funds was a deliberate, volitional act which was undertaken with the knowledge, cooperation, and assistance of staff from the certified public accounting firm that has contracted with the School District to operate its Business Office.

- On May 1, 2013, School District officials defaulted on a $1.4 million debt service payment related to energy bonds which the School District issued in 2006. Due to the School District's default, the debt service payment in question was made by a third party which had insured the bonds. As a result, the School District now is liable to the bond insurer.

- As of June 30, 2013, the School District had accumulated approximately $33.0 million in unpaid bills to various vendors. This amount included $6.9 million owed to the Oakland County Treasurer's Office in connection with various property tax delinquencies; $4.9 million owed to the State's Office of Retirement Services in connection with the Michigan Public School Employees Retirement System; $4.1 million owed the State School Loan Revolving Fund; $1.4 million owed to a bond insurer related to the default on energy bonds noted above; $1.4 million owed to Oakland Schools; $1.1 million owed for utilities; and $3.73 million owed to Michigan Education Special Services Association for health care insurance, which is in addition to the $7.8 million judgment levy noted earlier. Concerning the last unpaid bill, the Michigan Education Special Services Association notified School District officials on June 25, 2013, of its intent to terminate health insurance coverage for School District employees as of July 31, 2013. [5]

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[4] Section 705(1) of Public Act 34 of 2001, the Revised Municipal Finance Act, provides, in part, as follows:

> Debt retirement funds, except in the case of a common debt retirement fund maintained by a school district pursuant to section 1223 of the revised school code, 1976 PA 451, MCL 380.1223, shall be accounted for separately and, debt retirement funds, except as provided in section 701(5) [regarding pooled investments], *shall be used only to retire the municipal securities of the municipality for which the debt retirement fund was created*. Emphasis supplied.

[5] The May 20, 2013, preliminary review by the Superintendent of Public Instruction noted the existence of an ongoing investigation of the School District by the Federal Bureau of Investigation. The Review Team also was made aware of the existence of the investigation, but was not advised concerning the nature, scope, or status of the investigation. The Review Team also was advised by Oakland County officials of possible improper conduct among certain School District security personnel.

2. Review Team Meetings

On July 10, 2013, Review Team members met with Glenda Rader, Office of State Aid and School Finance, Michigan Department of Education; and with Anil Sakhuja, Rajeev Shah, and Karthik Ramaswamy, of the certified public accounting firm Alan C. Young & Associates.

On July 15, 2013, Review Team members conducted a series of interviews in the School District with Kelley Williams, Interim Superintendent; Caroll Turpin, School Board President; Karen Cain, School Board Vice President; Sherman Williams II, School Board Treasurer; S. Barbara Raby, School Board Secretary; and School Board members Brenda Carter, Mattie Hatchett, and Susan Loveland; Paul Bryant (Plante Moran), Business Office Manager; Dawn Demick, Human Resources Director; Robert Englund, Director of Facilities and Physical Plant Services; and Robert Taylor, Director of Pupil Management.

On July 17, 2013, Review Team members conducted a series of interviews in the School District with Aimee McKeever, President, Pontiac Education Association; Dan McCarthy, Union Services Director, Michigan Education Association; Larry Redmond, Vice President, Pontiac Paraprofessional Instructors Association; Charita Wright, President, Pontiac Educational Secretaries Association; Alicia Carpenter, Secretary, Pontiac Educational Secretaries Association; Fern Dowell, Secretary (Negotiation Team), Pontiac Educational Secretaries Association; Robert Moore, Jr., Deputy Superintendent for Finance and Operations, Oakland Schools; Lisa Swansey, Acting President, Pontiac Educational Support Personnel; Jacqueline McDougal, Vice President, Pontiac Association of School Administrators; and Steve Cunningham, President, Pontiac Police Authority Officers.

Also, on July 17, 2013, Review Team members conducted a public information meeting in the Pontiac School District pursuant to Section 5(2) of the Local Financial Stability and Choice Act. The Review Team informed School District residents in attendance of the statutory scope of its responsibilities, indicated that the Review Team had met with various School District and union officials, and received comments from approximately 20 School District residents concerning the financial condition of the School District.

3. Other Considerations

During the course of discussions with various officials, the Review Team concluded that the process by which School District officials have made decisions, the officials involved in those decisions, and the aftermath of certain significant decisions that have been made, cast doubt upon the continuing financial and operational viability of the School District. This is so for several reasons.

<u>Poor Communication</u>. First, there appears to have been, and remains, a lack of effective communication, both within the School District's administrative structure and between that administrative structure and the School Board. It is noteworthy that the School District and union officials which

the Review Team interviewed expressed the nearly unanimous sentiment that the current Interim Superintendent has significantly improved communication and transparency since assuming that role in May of 2013, and that she possesses an admirable determination to alter the School District's recent declining trajectory. Nevertheless, issues remain.

Several School Board members expressed frustration at their inability to receive timely and accurate information regarding the financial and operational activities of the School District. It was observed that financial information received from the contractual staff in the School District's Business Office may subsequently change without notice or explanation. Indeed, even a School District administrative official indicated that the School District has asked the Oakland County Treasurer's Office to review and verify much financial information provided by the School District's Business Office, suggesting either a lack of effective communication by the Business Office or a lack of confidence in its work product.

School Board Dysfunction. Interviews with various individuals disclosed significant dysfunction within the School Board. Several School Board members expressed their desire to avoid micromanaging operations of the School District. Nevertheless, there also were demonstrated instances in which School Board members appear to have overreached their responsibilities by becoming involved in contract evaluations and selections, had direct interactions with administrative staff regarding issues that seemed better suited for the superintendent, and intervened in vendor and union relations.

Second, School Board members expressed differing views concerning whether they had retained a certified public accounting firm to conduct the School District's financial audit for the 2013 fiscal year, which ended June 30, 2013. Some School Board members were of the opinion that such a resolution had, in fact, been adopted while other School Board members were not certain. As noted earlier, the School District's 2012 financial audit report was filed four months late, which resulted in the Michigan Department of Education having to withhold State school aid. It appears uncertain whether the financial audit for the fiscal year just concluded will be conducted timely.

Furthermore, the Review Team found it worthy of remark that most School Board members only made tangential reference during our discussions with them to serving the needs of the students of the School District. One would have thought the needs of the students would have been of paramount concern to each and every School Board member, given the demonstrated importance of a well grounded elementary-secondary education, the number of at risk and special needs students in the School District, the School District's decline in student enrollments, and the worsening financial plight of the School District.

C. Conclusion

Based upon the foregoing information, meetings, and review, the Review Team confirms the findings of the preliminary review, the determination of the Local Emergency Financial Assistance Loan Board, and concludes that a financial emergency exists within the Pontiac School District.

II. Section 5(3) Requirements

Section 5(3) of the Act requires that this report include the existence or an indication of the likely occurrence of any of the conditions set forth in subdivisions (a) through (m).[6] The conditions in subdivisions (b) (iii), (d), (e), (f), (g), (j), and (k) of Section 5(3) exist or are likely to occur, as follows:

- As previously noted, School District officials failed to remit the Michigan Public School Employees Retirement System approximately $4.9 million in employer and employee contributions for the period ending June 30, 2013. (Section 5(3)(b)(iii).)

- The School District had a general fund deficit of $37.7 million as of June 30, 2013, which was not eliminated within the two-year period preceding the end of the fiscal year of the School District during which this Review Team report is received. (Section 5(3)(e).)

- The projected general fund deficit of $15.8 million as of June 30, 2014, exceeds 5 percent of the $72.6 million in general fund revenues which the School District has budgeted for the 2014 fiscal year as reported in its fiscal year 2014 budget. (Section 5(3)(f).)

- As previously noted, School District officials failed to abide by the terms of a previous deficit elimination plan resulting in the Michigan Department of Education withholding State school aid. (Section 5(3)(g).)

- A structural operating deficit has existed in the School District's general fund during the last three fiscal years in the amount of $1.6 million in fiscal year 2010, $10.7 million in fiscal year 2011, and $11.2 million in fiscal year 2012. (Section 5(3)(j).)

- As previously noted, School District officials utilized debt retirement funds to satisfy School District payroll obligations. (Section 5(3)(k).)

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[6] Subdivisions (a) through (m) of Section 5(3) of the Act provide as follows:

> (a) A default in the payment of principal or interest upon bonded obligations, notes, or other municipal securities for which no funds or insufficient funds are on hand and, if required, segregated in a special trust fund.
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> (b) Failure for a period of 30 days or more beyond the due date to transfer 1 or more of the following to the appropriate agency:
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> (i) Taxes withheld on the income of employees.
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> (ii) For a municipal government, taxes collected by the municipal government as agent for another governmental unit, school district, or other entity or taxing authority. (Continued on next page)

III. Review Team Report Transmittal Requirements

Section 5(3) of the Act also requires that a copy of this report be transmitted to Pontiac School District Interim Superintendent Kelley Williams, the Pontiac School Board, the Speaker of the House of Representatives, the Senate Majority Leader, the Superintendent of Public Instruction, and each State Senator and Representative who represents the Pontiac School District.

cc: Kelley Williams, Interim Superintendent
Pontiac School Board
James Bolger, Speaker of the House of Representatives
Randy Richardville, Senate Majority Leader
Mike Flanagan, Superintendent of Public Instruction
Jim Marleau, Michigan Senator
Tim Greimel, Michigan Representative

(iii) Any contribution required by a pension, retirement, or benefit plan.

(c) Failure for a period of 7 days or more after the scheduled date of payment to pay wages and salaries or other compensation owed to employees or benefits owed to retirees.

(d) The total amount of accounts payable for the current fiscal year, as determined by the state financial authority's uniform chart of accounts, is in excess of 10% of the total expenditures of the local government in that fiscal year.

(e) Failure to eliminate an existing deficit in any fund of the local government within the 2-year period preceding the end of the local government's fiscal year during which the review team report is received.

(f) Projection of a deficit in the general fund of the local government for the current fiscal year in excess of 5% of the budgeted revenues for the general fund.

(g) Failure to comply in all material respects with the terms of an approved deficit elimination plan or an agreement entered into pursuant to a deficit elimination plan.

(h) Existence of material loans to the general fund from other local government funds that are not regularly settled between the funds or that are increasing in scope.

(i) Existence after the close of the fiscal year of material recurring unbudgeted subsidies from the general fund to other major funds as defined under government accounting standards board principles.

(j) Existence of a structural operating deficit.

(k) Use of restricted revenues for purposes not authorized by law.

(l) The likelihood that the local government is or will be unable to pay its obligations within 60 days after the date of the review team's reporting its findings to the governor.

(m) Any other facts and circumstances indicative of local government financial emergency.